FUNDING OF RETIREMENT BENEFITS IN RELATION TO THE LABOR LAW

By now, the Indonesian Law No. 13/2003 (the Labor Law) introduced earlier this year on 25 March 2003 should have been familiar amongst those who deal with human resources in various organizations. The Labor Law sets out the minimum mandatory payment of benefits when an employee leaves a company. We recall that in our previous article on "Managing Post-employment Benefits post Labor Law: Design Aspect", we set out some thoughts on designing retirement benefits in view of the mandatory benefits set out in the Labor Law. Although very briefly, we also discussed some options in funding of the retirement benefits mandated by the Labor Law. The Labor Law does not make it compulsory to fund the benefits. However, during the past few months, more and more companies have approached us to discuss what options are available if a company wishes to fund the benefits.

In this article, we hope to discuss some of the funding options as well as factors that need to be considered when making a choice of funding arrangement. Note that although we will be focusing on the post-employment benefits mandated by the Labor Law, in practice, the points that will be discussed in this article will also be appropriate for other unfunded post-employment benefits. Note also that most of the thoughts here will be most relevant to companies that have not yet established Pension Fund or Dana Pensiun (as approved by the Minister of Finance).

FUNDING NATURE AND VEHICLES

First of all, let us define funding. Funding, throughout this article is defined as the act of setting aside some fund, through contributions, premiums, or fund savings, either to a third party or to a plan managed internally. Payment of benefits, when it is due, is then made out of this fund.

Funding arrangement can take a number of different forms through several funding vehicles. The basic funding nature can be categorized into either:

- **Defined Benefit (DB)**: where benefits are pre-determined as a multiple of final salary and length of service, but the amount of fund that goes into the plan – that is, the contribution – is determined through actuarial calculation and may vary from year to year.

- **Defined Contribution (DC)**: where the amount of fund that goes into the plan – the contribution – is pre-determined as a percentage of salary, but the benefits at the end of the contribution period will depend on the accumulated fund plus interests.

- **Combination of DB and DC (hybrid)**: where certain characteristics of a DB plan and those of a DC plan are combined

The following table compares each type of funding arrangement above.

Characteristics	**DB**	**DC**	**Hybrid**
Amount of benefits	Fixed in terms of a formula based on salary and length of service	Depends on the fund accumulation	Usually depends on the fund accumulation, but interests on fund are usually fixed or guaranteed above certain level
Contribution levels	Variable	Fixed in terms of percentage of salary	Usually fixed in terms of percentage of salary

Investment risks	Borne by the company; company will cover for poor investment results	Borne by the employees; poor investment returns will result in reduced amount of final balance of fund accumulation	Usually borne by the company, as company guarantees minimum investment results

Now that we have identified the basic funding arrangements, we shall than look at the options of funding vehicles available. Given the fact that funding of post-employment benefits as mandated by the Labor Law is not compulsory, we can have the flexibility of choosing the most suitable funding vehicle, depending on various factors that we will be discussion in later section. Below are the choices of vehicles that we can choose to fund the post-employment benefits.

- Employer Pension Fund
- Financial Institution Pension Fund
- Insurance plans :
  - Endowment plan
  - Savings plan (Pooled Fund or Individual Account)

The table below compares some characteristics of the above vehicles.

Characteristics	**Employer Pension Fund**	**Financial Institution Pension Fund**	**Insurance Plan**
Plan nature	DB or DC	DC	DB or DC
Plan Provider	Employer through a separate legal entity	Bank or Insurance Company through a separate legal entity	Insurance company
Investment risks	Borne by Employer	Borne by Employee	Borne by Employer, Insurer, or Employee
Tax incentives	Yes, depending on the profit and loss situation of Company	Yes, depending on the profit and loss situation of Company	No
Benefit vesting	Deferred vesting, to 3 years of participation in the pension fund	Benefits immediately vested	Flexible, depending arrangement by Employer
Benefit payment	Benefits paid on monthly basis, with allowance for lump-sum payment up to certain limit	Benefits paid on monthly basis, with allowance for lump-sum payment up to certain limit	Benefits paid in lump-sum
Fund arrangement	Pooled fund	Individual account of Employee	Pooled or individual account, depending on arrangement by Employer

FUNDING NEED AND CONSIDERATION

In previous section we have identified the basic nature of funding (DB, DC, or hybrid), and compared some of the main characteristics the funding vehicles. The next step is to examine whether or not funding is an option, that is, to ask these questions: is funding necessary? What advantages can we get from funding?

We shall look at the some of the main considerations when making a decision whether to fund or not to fund post-employment benefits. To start off, we can consider the following questions as the starting point:

- What are the goals to be achieved and the supporting reasons that necessitate funding of the post-employment benefits?
- What are the drawbacks of funding?
- Are the required resources available to ensure achievement of funding goals?
- What relevant options are there available to choose from?

Different companies will have different reasons that may prompt the requirement for funding. However, the most common goal is that they want to ensure that when benefits payment is due, they have sufficient fund to cover that payment without having a significant impact on the cash flows of the company. Funding can be useful in this regards, as the company starts setting aside some funds systematically and on a regular basis years before payment is due.

Other supporting reasons that may be considered in making the decision to fund post-employment benefits include the following.

- financial prudence; the fact that the funds for benefits payment are normally segregated from the assets of the company makes funding relatively more secure from the employer's point of view, and to a greater extent, from the employees' point of view
- compound interest earned on the fund; through simulations, we can show that a significant 36% to 45% of total fund balance at the end of 15-year's funding will come from interests earned on the funds; we can easily show that the longer the contribution period, the greater the portion of the fund balance that will come from interests [1]
- possibility of tax advantages; if the funding is done through either Employer Pension Fund or Financial Institution Pension Fund, contributions to the pension fund are taxed deductible; returns on investment of the pension fund in time deposit and listed shares (at the Jakarta Stock Exchange) are not taxed
- more manageable cash flow planning; contribution rates are normally within a predictable range (for instance, 5% to 10% of salary, depending on the level of benefits that the company wants to achieve through the funded plan), making it relatively easier to manage cash flows when expected outflow of cash can be estimated in advance

However, funding does not always mean advantages. Perhaps one of the main drawbacks, if we can call it that, of funding of post-employment benefits is the increased administration work. The company needs to have a consistent and up-to-date record-keeping for the funds

[1] Figures are indicative only, based on 7% - 9% annual net investment return and 6% - 8% annual salary increase. Results will vary as the actual return and increase change.

that have been set aside. Although this is normally done by the administrator of the plan, internal record-keeping is still required.

In addition to the additional administration works, there are some other challenges that need to be taken into consideration, such as the manner of payment (lump-sum versus monthly payment) and flexibility to change funding or benefit arrangement. However, given the available funding vehicles as discussed in previous section, these challenges may be addressed by selecting the suitable vehicle.

The next consideration that we need to take into account in the decision making process of funding of post-employment benefits is availability of resources. The required resources can be either internal or external resource or a combination of both, depending on the funding arrangement. Let us take a closer look at the types of resources required and the areas where they are required, both in the case of self-managed plans and outsourced plans. The resources include people, technology/system, as well as access to information.

A plan that is managed internally (self-managed) can be established for instance through Employer Pension Fund. For internally managed plans, resources are normally required for:

- administration of data, contribution and benefit distribution; having an accurate recordkeeping is essential in ensuring that up-to-date information concerning data, contributions, and benefits are readily available

- management of fund investment; precise and timely information on asset management and allocation is also essential to ensure most beneficial investment decisions

- employee communication; information concerning the plan need to be accurately and completely communicated to the employees or plan participants to increase awareness, appreciation and employee education

- compliance and reporting; especially for Employer Pension Funds, regular and timely reporting is required as mandated by prevailing regulations

Aside from establishing an internal plan, we can also outsource the management of the plan through Financial Institution Pension Funds, insurance companies, or fund managers. It should be noted however that ability and availability of plan providers will heavily depend on the complexity of the benefits design the company wishes to adopt. Some providers may not have the capacity to manage certain plans with specific characteristics requirement imposed by the company. Of course, the above points regarding resources requirement will still be relevant for outsourced plans. However, effectiveness of the outsourcing will be greatly influenced by the company's knowledge of the market players, the process of provider selection, documentation and communication as well as regular monitoring on the performance of the third party.

FUNDING APPROACH AND SELECTION OF VEHICLES

Funding of post-employment benefits should be viewed as a long term commitment. In an organization with relatively young workforce, this commitment could take a time horizon of as long as 25 – 30 years. Clearly, this implies the need to carefully and thoroughly examine all related aspects as we have discussed in the previous sections when approaching, exploring and adopting a funding strategy. Graph 1 below shows a general approach of funding decision process.

Logically, the first step in the process is to clearly set out the objectives that we wish to achieve through funding. At this step, the general design of the benefits to be funded need to have been defined, including the constraints that the company might have.

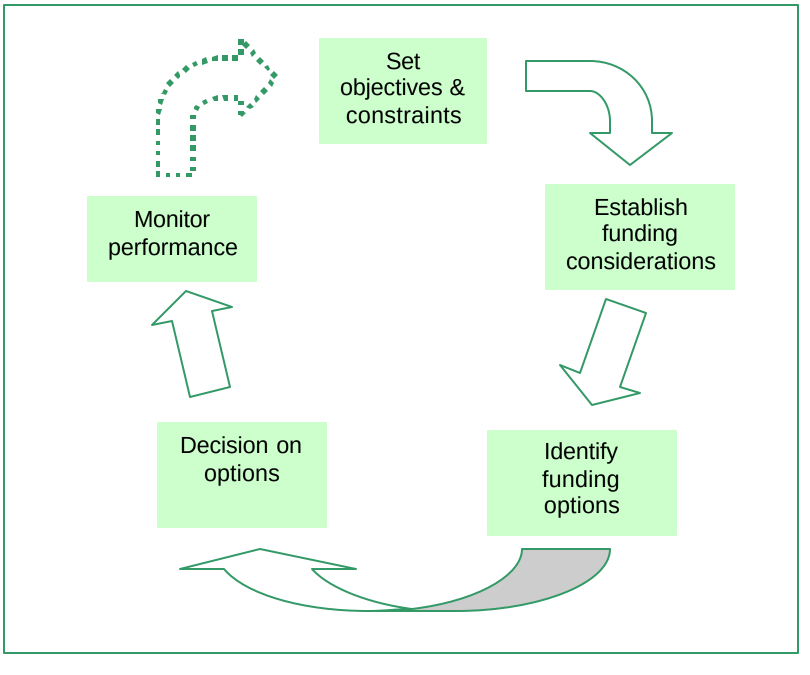
Having set out the objectives, the next step is to carefully examine all consideration factors. Many of these factors have been generally discussed in the previous section of this article. Having clearly defined objectives will facilitate this stage of the process.

Once we have set the objectives and considered all factors that we need to take into account to ensure achievements of the goals, the next stage is to identify all options available. Clearly, factors that we have considered in the previous step will be of great importance in this point because we want to make sure that whatever option that will be chosen has to address all the factors and possibly concerns that might arise.

This leads us to the subsequent step, the decision on options. While this step may seem straightforward to some, this is arguably the stage that will have the most significant influence to the success of the whole process. It is essential that the selection on options be carried out with thorough examination of various aspects that have been identified in the funding consideration step.

Finally, after a particular option has been selected and put in place, the performance of the plan needs to be evaluated on a regular basis. This is to ensure that the objectives of the funding can be met, not only those that are defined at the beginning of the decision process, but also to address any issues that may arise after the plan has been established.

Graph 1 : Approach for funding of post-employment benefits



Let us now look at some of the points that we need to take into account when selecting the most suitable funding vehicle. In previous sections we have set out the different characteristics of some types of funding vehicle. In very few cases, funding vehicle selection may be as simple as selecting one that has all the preferred characteristics. However, in most cases, it is almost impossible to have a vehicle that has all the desired characteristics. The selection process will then involve the process of balancing the pros and cons of the vehicle options.

This selection process consists of identifying and differentiating the characteristics as the selection criteria. The characteristics are then weighted based on their importance to the success of the funding objectives. The process then continues with finding a consensus on the vehicle to be selected based on the criteria weighting.

Some of the main criteria that we can identify to assist in the vehicle selection process may include the following.

- Availability of internal resources; this is important as certain types of funding are not easily outsourced, for instance, outsourcing a DB plan is only possible with insurance companies (without the tax advantages available if managed internally)

- Segregation of assets and tax incentives; this can only be achieved through Pension Fund as approved by the Minister of Finance, either Employer Pension Fund or Financial Institution Pension Fund

- Manner of benefit payment and flexibility of vesting; lump-sum benefits payments are not possible through a Pension Fund

- Bearer of investment risks; for instance, in DB plan Employer bears the risks, in DC plan: Employees, while in endowment plan: the insurer

CLOSING

We have discussed throughout this article the advantages of having a systematic funding of post-employment benefits, such as tax incentives, interests on fund, and sharing of risks. We have also set out several options that companies can choose to adopt in terms of funding nature (DB, DC, or hybrid), as well as the available funding vehicles.

Before proceeding with any particular funding option/vehicle, various aspects need to be carefully examined. These aspects include, but not limited to having clear objectives that we wish to achieve through funding, having a clear benefits design that we wish to fund and identifying factors/characteristics that wish to have in the funding vehicle. There is no "one-size-fits-all" when it comes to benefits funding as each organization has distinct funding goals, employee culture that it wishes to support and the company's philosophy on compensation and benefits. A selection of all the characteristics of the funding options is then required to ensure appropriateness of funding vehicle chosen.

We need to keep reminding ourselves that funding is a long-term commitment, the success of which will be greatly influenced by the decision we make at the start of the commitment.

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